

Dialogue: Outside Director × Institutional Investor

Corporate Governance: Supporting Sustainable High Growth of the IHI Group

In order to move forward with the medium-term management plan Group Management Policy 2023, the role of outside directors in corporate governance is crucial.

The four outside directors exchanged opinions on the current state of corporate governance in the IHI Group along with other issues, with institutional investor Zuhair Khan as facilitator.

(Date: July 2023; Venue: IHI Club Hall)



Medium-term management plan 2023 to 2025 “Group Management Policies 2023”

Zuhair Khan (hereinafter, “Khan”): UBP Investments manages stocks with a focus on the governance of Japanese companies, and believes that the key to governance is the Board of Directors. The Outside Directors of IHI consist of members with extensive backgrounds. Today we would like to have a discussion based on your diverse experiences.

First, let me ask you about the “Group Management Policies 2023”. In the “Group Management Policies 2023”, which has a strong focus on the life cycle and value chain perspective, the businesses of the IHI Group are classified into three businesses: the Growth Business (Aero Engines and Space), the Development-focus Business (Clean Energy including ammonia), and the Core Businesses (Resources, Energy & Environment, Social Infrastructure, Industrial Systems & General-Purpose Machinery). I understand that the business transformation IHI is trying to promote here requires active investment. What kind of internal discussions are conducted regarding the time frame for investment recovery and monetization?

Usui: Although we have not yet fully discussed the time frame for monetization, we must establish a solid business model by 2030 regarding Clean Energy such as ammonia, which is positioned as Development-focus Business. Regarding our ammonia business, the IHI Group aims to play a central role in the entire supply chain, from fuel production, storage & transport to utilization. However, it will take some time to establish such a business model, as it depends heavily on the energy policy of each country. Aero Engines, which we position as Growth Business, is very well situated in the global supply chain and is an area that is expected to continue growing. To propel this growth, we need to further strengthen our business foundation, including production technology, and increase our presence in the market. An aircraft is a complex system assembled with many parts. In addition, increasingly advanced technologies must be incorporated to meet the

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accelerating demand for fuel efficiency and to attain strict certifications. For these reasons, it takes time for R&D investment, commercialization of the product, and achieving profit.

In the areas that we have positioned as Core Businesses, we must carry out structural reforms and increase profitability to generate investment funds to be allocated to the Development-focus Business and Growth Business.

Khan: I think it is necessary to sell off assets and non-core businesses in order to secure funds for investment in Development-focus Business and Growth Business, which will eventually become core businesses. Are you having thorough discussions about such issues?

Matsuda: By defining the Growth, Development-focus, and Core Businesses and clarifying the business portfolio, we have completed the foundation for discussions on future

investments. Following the previous medium-term management plan, Project Change, the Board of Directors including myself have been able to share a common concept of the business portfolio. Now, we are gradually able to discuss efficient use of capital, including asset sales. I believe that the discussion of business and investment priorities will become a central topic of discussion for the Board of Directors in order to avoid missing out on business opportunities.

Usui: There are various businesses in the Core Businesses. While there are technologies within such businesses that are important to the IHI Group, I feel that the businesses are not necessarily competitive. It will be necessary to change the business structure to achieve more synergies by consolidating core human capital, technology, and customer base. We should concentrate our management resources to where we can compete on a global scale,

including our subsidiaries. By improving the profitability of the Core Businesses with large revenue and securing investment resources, we can make proactive investments in the Development-focus and Growth Businesses. I believe that the market will understand the need to secure funds and make investments in this way.

Khan: I believe that business transformation through digital transformation (DX) must be accomplished in order to increase the profitability of the Lifecycle Businesses. How do you evaluate DX strategy and securing of DX human capital?

Usui: The IHI Group's strength lies in hardware. We should leverage this strength and implement DX solutions for our businesses to increase productivity and competitiveness. We will need to be open to various possibilities, including partnerships with other companies.



Chairperson of Remuneration Advisory Committee
Nomination Advisory Committee Member

Yoshiyuki Nakanishi



Nomination Advisory Committee Member

Chieko Matsuda



Remuneration Advisory Committee Member
Nomination Advisory Committee Member

Minoru Usui



Remuneration Advisory Committee Member
Nomination Advisory Committee Member

Toshihiro Uchiyama



UBP Investments Co., Ltd.

Zuhair Khan

Joined UBP Investments in 2019 as head of equity management strategy focused on governance of Japanese companies. Prior to that, he was head of research and strategist for Japanese equities at a U.S. securities firm. His research and analysis products on corporate governance of Japanese companies have been highly evaluated by institutional investors worldwide.

UBP Investments: Japan Office of Union Bancaire Privée, an asset management company based in Geneva, Switzerland.

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Matsuda: IHI has excellent human capital and technologies, however there are three issues that need to be improved. First, the company has a weak spot in considering overall optimization. Second, it lacks the ability to form business designs. In other words, the design of individual parts is superb, which is an advantage, but the business as a whole needs to be designed with the market and competition in mind. Third, there is a lack of speed. With the understanding that something must be done to address these issues, we formulated the “Group Management Policies 2023,” which focuses on transformation. In order to promote business transformation through DX, it is important to improve the three issues mentioned. We will also promote behavioral change in addition to awareness-raising.



Khan: I feel that there is a large room for improving profitability through business transformation. What is the expected profitability impact when business transformation is steadily implemented over the medium to long term?

Matsuda: If the transformation can be realized, I expect that profitability can be expanded, for example, to twice the current level. On the other hand, the hurdles that need to be overcome in order to realize this goal are also in sight, so now is the time to press on.

Nakanishi: The Clean Energy area of the Development-focus Business is a promising business. If

The Ammonia Value Chain will be established through bold investment and strong presence as a main player in the market, contributing to an increase in profitability.

Usui: Until 2030, we expect that the Growth Business will drive profitability improvement. The Core Businesses are also capable of achieving a stable double-digit profit margin. Furthermore, by investing the cash generated from these businesses in the Development-focus Business, we can greatly accelerate the growth of Clean Energy in and after 2030, which could be a game changer for the IHI Group. As you can see, IHI has the ability to become a high-growth and highly profitable company, and I will closely track its progress.

Uchiyama: Regarding the Development-focus Business, new developments related to Clean Energy are reported daily in the media around the world, making it a very exciting business. We would also like to aim for at least double-digit operating profit margin. One way to accomplish this is to pick a company as a benchmark. With the right benchmark, we will be able to set realistic targets.

Board Structure

Khan: We focus on the number of Board Members when assessing governance. When the number of Board Members is too large, we see cases where governance is inadequate. The Board of Directors of IHI is composed of 17 members, including 12 Directors and 5 Audit & Supervisory Board Members. What are your thoughts on the effectiveness and appropriate size of governance?

Usui: IHI has 12 Directors, which is more than other companies in general. However, the discussions center on the internal Directors with representation, the Outside Directors, the outside Audit & Supervisory Board Members, and the Director in charge of finance, which is not substantially different from Seiko Epson Corporation (hereinafter, “Seiko Epson”) where I chair the Board of

Directors. I do not see a problem with streamlining the Board of Directors in the future.

Uchiyama: NSK Ltd. (hereinafter, “NSK”) reduced the number of Board Members from 12 to 9 and increased the number of Outside Directors to a majority. The reason for reducing the number of internal Directors is to make the Board of Directors a place where everyone can actively participate in discussions. Internal Directors in charge of business execution are reluctant to participate in discussions outside of their own areas of responsibility, and they may have a psychological tendency not to oppose or criticize other matters in order to gain support for their own agenda, so they inevitably speak out less. NSK has been able to maintain the depth and neutrality of discussions by reducing the number of Board Members and having the Representative Director, Outside Directors, and Directors who are the Audit & Supervisory Committee Members take the lead in discussions, and having the Executive Officers who are responsible for business execution provide explanations as necessary. During my term as President and Chief Executive Officer, I myself was anxious about whether or not the proposals would pass, but it is true that I was able to approach the meeting with a sense of urgency.

Khan: In IHI, both the Board of Directors and the Nomination Advisory Committee are chaired by internal Directors. What do you think are the advantages and disadvantages of having Outside Directors in these positions?

Matsuda: From the viewpoint of an investor's evaluation, I think there are more advantages in having the Outside Directors in these positions. Investors tend to judge the effectiveness of governance first on the basis of external factors, so I think this has the advantage of making it easier for investors to evaluate the effectiveness of governance. In addition, there is an advantage in having more external views reflected. That said, it does not mean that the functionality of the Board of Directors or various

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committees is compromised if they are chaired by internal Directors. Essentially, what is important is that there is mutual trust and sufficient communication between the board's chairman/committee's chairperson and the Outside Directors to ensure effectiveness.

Uchiyama: There is also an option of appointing an internal Director who is not involved in business execution as a chairman of the Board of Directors. In fact, an internal Director who is not involved in business execution is the chairman in NSK. Having an Outside Director serve as chairman has advantages in terms of guaranteeing independence. On the other hand, if the chairman of the Board or the committee does not have sufficient understanding of changes in the market environment or technology trends, discussions may not be fruitful.



Nakanishi: The Chairman who does not have representation and is not involved in business execution chairs the Board of Directors also in DIC Corporation. Investors may value having an Outside Director serve as the chairman. However, the choice of whether the chairman should be from outside or inside the Company is not an easy one to make, considering the operational aspects of the Board meetings.

Usui: The business structure of the IHI Group is complex, thus I feel that it is quite difficult for an Outside Director to chair the Board of Directors. Meanwhile, it is also true that

the nomination of a successor to the next President requires the involvement of Outside Directors from the perspective of ensuring objectivity and transparency. Therefore, I believe that it is more persuasive to stakeholders if the Nomination Advisory Committee is chaired by an Outside Director.

Khan: There is an option to have a lead Outside Director to improve communication between internal and Outside Directors.

Usui: I agree that communication among Outside Directors will be easier if a lead Outside Director is appointed. In current Board discussions, there is no opportunity for Outside Directors to exchange views with each other in advance. Since each Director expresses his or her own views at the Board meetings, the reality is that it is difficult to see where the consensus of the Outside Directors lies. Having a lead Outside Director compile the opinions of the Outside Directors would most likely further deepen the discussion at the Board meetings. In Seiko Epson, a forum for discussion has been set up that is limited to Outside Directors. This is worth considering in IHI as well.

Nakanishi: Another company for which I serve as an Outside Director has a lead Outside Director, and depending on the agenda, the opinions of the Directors are aggregated in advance. These opinions are reported to the President as a consensus of the Outside Directors; thus, I feel that issues will be clearer from the perspective of the internal Directors. The Lead Outside Director, on the other hand, will have an added responsibility as a coordinator, thus it is necessary to review the system design, including remuneration.

Officer Remuneration

Khan: In European and U.S. companies, the standard remuneration for Outside Directors is a base remuneration of \$100,000, with an additional \$50,000 for committee

members, and an extra 50,000 dollars for chairmans/chairpersons, depending on his/her workload. About half of the remuneration is in the form of grants of restricted stock, which often makes the remuneration system more in line with the shareholders' viewpoints. I feel that there is room for Japanese companies to incorporate such ideas.

Usui: I agree with increasing share remuneration. Seiko Epson has introduced share remuneration as part of the remuneration package for its internal Directors. The introduction of share remuneration has fostered a sense that Directors take the initiative in owning their company's shares, and Outside Directors have also voluntarily acquired a reasonable number of shares through Directors' shareholding associations. I feel that by owning shares, Outside Directors have been able to see things from the shareholder's point of view and have formed the foundation for good discussions.



Khan: The main KPIs for the performance-based portion of IHI's remuneration for officers are consolidated profit, consolidated operating cash flows, consolidated ROIC, and individual performance evaluation based on the mission of each officer. What kind of discussions have been conducted in the Remuneration Advisory Committee in terms of an evaluation axis for incentive remuneration?

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Nakanishi: In our current management, we emphasize consolidated operating cash flows, which is the evaluation axis for incentive remuneration. However, the targets are set quite high, and despite the fact that the Company achieved a record level of profit in the previous fiscal year, the performance-based bonus is not that high, giving the impression that they are somewhat unbalanced. In addition, we are currently discussing ways to improve the indicators since they do not incorporate year-on-year improvements, growth values, and non-financial perspectives.



Usui: Since there were very difficult times in IHI, I assume that the evaluation axis for incentive remuneration was determined with a strong enthusiasm to improve cash flow. However, other issues have arisen now. For example, I think the evaluation should incorporate more perspectives on all external factors such as the business environment and the progress of long-term development and structural reforms that are not immediately linked to operating results. I believe that establishing a mechanism to benefit from rising stock prices from the perspective of ESG management, which is an important policy of the IHI Group, is the direction we should take moving on. Discussions on these issues have already begun at the Board of Directors.

Khan: The majority of remuneration for the management of foreign companies is granted in the form of shares. In IHI,

20% of the total remuneration is share remuneration, but perhaps the ratio and level of share remuneration could be increased.

Nakanishi: I think it would be good to have a dynamic decision on changing the remuneration system based on IHI's unique approach, as we become more aware of our global business activities.

Usui: When a company is decisively implementing structural reforms, its stock price tends to be sluggish because its immediate performance is also difficult. However, in my experience at Seiko Epson, we have tried to grant as many shares of the company's stock as possible through share remuneration and director stock ownership plans in order to share the benefits with shareholders and with the belief that we will definitely improve the company's performance in the future. I believe that the IHI Group can also drastically increase the share remuneration because if we implement structural reforms and the corporate structure becomes stronger, this will be reflected in the stock price. I feel that having one's efforts reflected in future stock prices will increase the officer's incentive toward management and also the officer's sense of fulfillment after leaving the Company. This will also show the management's determination towards the shareholders.

Uchiyama: Managers must be aware of stock prices. Therefore, there is no doubt that share remuneration is an important element in the remuneration system for officers.

Matsuda: There is a discussion of the ratio of share remuneration, but before that, the level of remuneration for managers in Japanese companies is too low. If only the ratio of share remuneration is increased at the current level of remuneration amount, it is possible that officers will be short of cash for their immediate needs, which is not entirely a joke! I think the fact that the standard for disclosure of remuneration in securities reports is 100 million yen or more is also problematic, and I would like to

see more voices raised from the standpoint of investors regarding the state of executive remuneration in Japanese companies.

Khan: I am all for the increase in performance-based share remuneration, as long as the medium- and long-term metrics are reasonable. In my analysis, there is a positive correlation between the amount of company stock held by internal Directors and the increase in corporate value, and this correlation is particularly evident for companies with multiple internal Directors holding 100 million yen or more of the company's stock. As an investor, I would like to ask internal Directors who are responsible for business execution to hold a certain amount of shares through share remuneration.



Khan: Through today's discussion, I have gained a better understanding of the IHI Group's governance and long-term corporate value. In comparison with foreign companies, I feel that Japanese companies tend to underinvest in investor relations and provide less information than European, U.S., and Asian companies. I look forward to an active communication of the growth story of the IHI Group to investors around the world.